



MARLOWE & COMPANY

GOVERNMENT AFFAIRS CONSULTANTS

Memo

To: Marlowe & Company Clients

From: Toby Hicks, Legislative Aide

Re: Build America Bonds

Date: March 19, 2010

Executive Summary

In the wake of the collapse of the municipal bond market, local governments have struggled to secure valuable investor financing for their crucial projects. To combat this, President Obama included a valuable new program, Build America Bonds (BABs) in the American Recovery and Reinvestment Act to revive the municipal bond sector.

BABs are federally-subsidized finance tools that allow local governments to more easily access the larger corporate debt market. The federal government pays 35% of a BAB's interest rate so that the local government can effectively assume debt at a higher interest rate and thus be more attractive to investors. Since beginning the program in April 2009, BABs have successfully attracted investors to many municipalities and gained acceptance in the finance world. The program was originally scheduled to expire at the end of 2010, but it is likely to be made permanent at a 28% rate of federal subsidy.

Why Build America Bonds Have Worked

Initially BABs met resistance both in Congress and in Wall Street as many predicted the program would fail or would lead to a detrimental rise in local government borrowing.¹ This risk was reflected through higher underwriting fees as banks tried to locate new investors who would not have normally purchased municipal debt – some underwriting fees were as high as 200% the standard fee for tax-exempt issues.² However, the central premise of BABs was sound. By the end of February 2010, \$78 billion worth of BABs were sold and estimates predict 2010 BAB sales of \$100 billion or

¹ Gandel, Stephen. (2009). A stimulus success: Build America Bonds are working. *Time Magazine*, November 17, 2009, retrieved from <http://www.time.com/time/business/article/0,8599,1939720,00.html>.

² Dugan, Ianthe Jeanne. (2010). Build America pays off on Wall Street. *The Wall Street Journal*, March 10, 2010, retrieved from <http://online.wsj.com/article/SB10001424052748704869304575104101463410466.html?KEYWORDS=build+america+pays+off>.

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more.³ BABs can be issued for any purpose that would have been eligible for traditional tax-exempt bond financing other than private activity bonds.⁴

The amount that the federal government has offered to shoulder is currently 35% of the interest payment on BABs.⁵ This means that if a local government assumes debt through a BAB with an interest rate of 10%, the local government will pay 6.5% while the federal government pays 3.5%. BABs allow local governments to attract investors by offering interest rates that are much higher than the normal tax-exempt rates while simultaneously offering the lower risk and stability associated with government debt. There is currently no volume limit on the sale of BABs.

Initially there were also Recovery Zone Economic Development Bonds (RZEDBs) available as a subtype of BABs. RZEDBs were designed for communities that have significant unemployment or foreclosures, or that are economically distressed because of a change to a local military base, or are designated empowerment zones or renewal communities. In these bonds, the federal government shouldered 45% of the interest rate rather than the 35% BAB standard. RZEDBs however were limited to \$10 billion with each state guaranteed to receive at least 0.90% of that amount.

The Future of BABs

The BAB program authorized through the \$787 billion stimulus in 2009 is scheduled to expire at the end of 2010. But due to its success, President Obama and Congress are working to reauthorize it at slightly adjusted rates. The permanent program would begin on January 1, 2011 when the stimulus BAB program is set to expire. The new program would decrease the percentage that the federal government pays from 35% to 28%. The difference of 7% makes the BAB program revenue-neutral to the Federal government⁶ while continuing to help local governments attract investors.

For further information on this issue, please contact your Marlowe & Company team leader or email legislation@marloweco.com

³ Thiruvengadam, Meena. (2010). Total Build America Bond issuance hit \$78 billion at end-Fed Treasury. *Dow Jones Newswires*, March 19, 2010, retrieved from <http://www.nasdaq.com/aspx/stock-market-news-story.aspx?storyid=201003041352dowjonesdjonline000655&title=total-build-america-bond-issuance-hit-78-billion-at-end-feb-treasury>.

⁴ Maguire, Steven. (2009). Tax credit bonds: Overview and analysis. P. 12. Congressional Research Service.

⁵ U.S. Treasury Department. (2009). Build America Bonds and School Bonds: Investing in our states, investing in our works, investing in our kids. Office of Public Affairs, April 3, 2009, retrieved from <http://www.ustreas.gov/press/releases/docs/BuildAmericaandSchoolConstructionBondsFactsheetFinal.pdf>.

⁶ Lambert, Lisa. (2010). Obama to propose permanent Build America Bonds. *Reuters*, January 30, 2010, retrieved from <http://www.reuters.com/article/idUSTRE60T1VJ20100130>.